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MEMORANDUM

To: Sharon Edmundson, Lewis Andrews, Tim Romocki, Tony Blalock, Cindy Aiken and Sam Watts

From: Tom Lee and Paul Billow, Womble Bond Dickinson (US) LLP

Re: Senate Bill 265 - Bond Authorization Procedures

Date: April 1, 2021

The purpose of this memorandum is to provide thoughts and considerations on Senate Bill 265, which proposes changes to the North Carolina procedures for the authorization of general obligation bonds. We have discussed this bill with a number of the attorneys that practice municipal bond law in North Carolina. While we do not purport to speak for all the bond lawyers, we think the discussion below is in line with our discussions among them.

1. Background. At the outset, we want to point out that the North Carolina procedures for authorization of general obligation debt by local governments is very open and public. All actions required for the authorization and issuance of the debt are taken at public meetings; a public hearing after published notice is required for all new general obligation debt; in addition to the notice of public hearing, there are other required publications for the authorization of new general obligation debt; and all general obligation debt issues are subject to the independent review of the North Carolina Local Government Commission (the "LGC"). In addition, all records regarding the actions taken to issue the debt are public records under North Carolina law, and in addition to what is required by the public records law, most North Carolina local governments have made their authorization actions and proceedings readily available on-line.

In addition to conducting bond related activities in "sunshine," we observe that the overall culture on matters of public finance in North Carolina should be understood to be very conservative. North Carolina governments pay their debt, particularly their general obligation debt, at much faster rates than is common in most parts of the country. Most tax supported debt is structured on a "level principal" basis, meaning that principal is payable in equal annual installments and annual debt service reduces over the term of the bond issue, rather than a "level debt service" basis, which results in less principal being amortized in the early years and overall more interest cost. The typical final maturity of a general obligation bond issue in North Carolina is 20 years from the issue date, but the "average life," taking into account the level principal installments, is typically around 10 years. Under the federal tax laws for municipal bonds, a much later average maturity would be permitted for most bond issues.

In addition to these legal requirements, it is fair to say that the expected details of the bond issue and what it will mean in the way of debt service costs and the property tax rate is very much a part of the typical public discussion during the bond authorization process. It is standard procedure for a unit of local government considering a bond issue to consider how much debt it can afford, what it expects the cost of the proposed debt will be and how it will pay for it. One of the discussions that the LGC will have with any unit of government considering a bond referendum is how the unit is addressing these questions. In addition, from personal experience, we can attest that elected officials and local government staff are very mindful of the implications of incurring debt and its impact on tax revenues and tax rates.

The LGC is an entity that is unique to North Carolina; similar entities generally do not exist in other states. The primary role of the LGC is to provide oversight and assist local governments with managing its financial affairs and debt. The statutory safeguards that are already in place, which includes a required approval of all general obligation debt by the LGC, prevents local governments from incurring debt in a manner that would be detrimental to the governmental unit. The marketplace currently recognizes this benefit, and North Carolina issues typically sell favorable to similar issues in other parts of the country.

We would also point out that in 2013, to address similar concerns regarding whether adequate information was available to voters during the authorization process, the General Assembly revised the statutory procedures for the authorization of general obligation bonds to require that a "Statement of Total Estimated Interest" with respect to the proposed bonds signed by the finance officer of the local government unit be filed with the governing board of the unit at a public meeting and included in two separate notices published in the local newspaper. Additionally, G.S. 159-61 was amended to require the ballot question to specifically state that (a) the bonds will be repaid plus interest and (b) specifically state that taxes may be levied to pay the principal and interest on the bonds. These changes were specifically designed to alert voters that interest would be paid on the bonds, to provide an estimate of what that interest amount might be (based on reasonable assumptions as to the terms of the debt at the time such Statement is made) and to provide an express acknowledgement that taxes may be levied to pay the bonds.

2. The Referendum Ballot. Senate Bill 265 generally would change the current bond authorization process in two ways. First, it would require the LGC to obtain certain information from the issuing unit and include in its authorizing order (1) estimated debt service on the bonds based on certain stated assumptions, (2) the amount of tax increase necessary to pay the debt service on the bonds and (3) certain information relating to capacity to issue additional general obligation debt in the future based on reduction of outstanding general obligation debt. Second, Senate Bill 265 would require that such information be included in the ballot question. While we have a number of thoughts on the technical accuracy or applicability of the information to be provided (which is discussed below), we would first like to express our concerns with including such information in the ballot question, and specifically whether including such information, under certain circumstances, might result in invalidating the bond referendum.

Under the North Carolina Constitution, when a local government borrows money that will be secured by a pledge of its full faith and credit and taxing power (i.e., a general obligation bond), the bonds generally may be issued only if approved by a majority of the voters of the governmental unit voting in a bond referendum. Our courts have consistently held that the bond order submitted to the voters constitutes a contract between the governmental entity and the voters. When bond lawyers prepare general obligation bond proceedings and the ballot questions that will be submitted to the voters, we take great care in assuring that we are accurately describing to the voters what they are asked to vote on and that the question submitted covers everything the governmental unit is contemplating doing with the bond proceeds. Our concern with putting estimates and projections regarding interest costs, required property tax levies and other ancillary information in the ballot question is that such information, though made in good faith, might prove to be inaccurate or misleading (we will discuss below some of the circumstances that could result in such information being inaccurate or misleading). If such estimates and projections are in the ballot question itself, then the voters might argue when it is time to issue the bonds that the bond proposition they voted on at the time is not what is proposed now – and as a result is not the contract they agreed to with the governmental unit. For example, while a governmental unit may not have anticipated a tax rate increase to be necessary to pay debt service on the bonds when the bonds were originally authorized, a material loss in the tax base (loss of major taxpayers) might result in a need to increase the tax rate to pay the debt service on the bonds when the bonds are finally issued (which statutorily can be up to seven years, and in some cases 10 years, later). We could easily see a challenge to the bond issuance based on the fact that the governmental unit stated that no tax rate increase was expected. Such a challenge could jeopardize and delay the ability of the government unit to sell and issue the bonds for a needed capital project.

It might be possible to remedy this concern if there are enough assumptions, qualifications, exceptions and provisos included in the ballot question. Unfortunately, an election ballot is not a friendly forum to include all of these assumptions, qualifications, exceptions and provisos. For a ballot question to have all of these necessary qualifications would result in lengthy, and probably unreadable, bond question loaded with "legalese" that ultimately would not be helpful to anyone. Such an approach, we expect, would cause a loss of confidence by voters in the entire referendum process.

For these reasons, we strongly advise that the ballot question not include specific information regarding interest rates, interest costs, property tax increases, etc. This is not to say that such information (in some form) should not be part of the overall bond authorization process. This was the approach taken with the 2013 amendments discussed above, and we believe that it is the proper approach.

We note that when citizens vote for a particular candidate for office, the ballot only includes the name of the candidate, the office the candidate seeks and, in certain cases, the party affiliation of such candidate. There is no other ancillary information in the ballot regarding the candidate's views on a host of issues that might be important to a voter. It is generally incumbent on voters to research the candidate and his or her views, positions, etc. to make an informed decision. We believe that voters in bond referenda make their decisions similarly. Given the amount of public information that is already statutorily required to be made publicly available, together with other information that is customarily shared with voters during the bond authorization process (which in our experience is significant and is often shared on local government websites and other written materials broadly distributed to the public), voters have a great deal of information regarding the proposed bonds to be able to make an informed decision.

3. Specific Requirements of Senate Bill 265. While we hopefully have made the case for why the ballot question is not the proper vehicle for additional information regarding the bond issue, we would like to address our concerns regarding the specific information that is proposed to be provided in the bill. Before doing so, we want to emphasize that we do not believe that anyone in the bond community objects to making available relevant reliable information regarding what the proposed bonds during the referendum process. In fact, we believe that much of this information is already being disseminated by the governmental units or other parties during the process. While our discussions below address technical concerns with the specific information

required to be provided in the current version of the bill, we have no objection to the required disclosure of appropriate information, with appropriate assumptions and qualifications, being part of the bond authorization process where such disclosure makes sense.

(a) Estimated interest to be paid on the bond issue. Senate Bill 265 would require disclosure of "the total amount of interest estimated to result from the proposed bond issue using the highest interest rate charged when looking at the immediately preceding years for a term equal to the maximum issue term of the proposed bond[s]." (Note that we believe that an "s" should be inserted on "bond" at the end of such language.) We believe that this language is somewhat vague and unclear as to how to derive the specific estimate. We also believe that certain of the required assumptions would be unreasonable or improper for the reasons described below.

As stated above, the typical general obligation bond issue in North Carolina is structured with an overall 20-year term with level annual principal maturities. Thus, in the case of a $20 million bond issue, the bonds would typically mature annually in $1,000,000 installments generally beginning within one-year of the issue date.[1] This is just the typical structuring, and there may be circumstances that would call for a shorter overall maturity, a longer maturity, for principal to ascend over the term and so forth. On the typical yield curve, the longer a bond is outstanding, the higher the interest rate. Thus, a one-year bond maturity might have a rate in today's market of 0.50%, whereas a 20-year bond maturity might have a rate of 2.00%. An accurate statement of the estimated interest would need to take this all into account. It appears that the assumption of Senate Bill 265 is that there would be one interest rate for the entire bond issue. In such case, would the highest interest rate borne by any of the bonds be used or would some overall blended interest rate (i.e., true interest rate or average coupon for the entire issue) be used?

Complicating matters, the marketplace today is typically requiring that a maturity of bonds be sold with higher interest rates, but investors will pay a premium for the bonds. For example, a bond that would bear interest at a rate of 1% if sold to an investor at par is sold at an interest rate of 2%, but at a price equal to 115% of its par amount. This is a market driven result because bond investors in the current low interest rate environment want to protect the market value of their portfolio from falling below its par value if interest rates increase later. This results in issuers paying higher interest rate on premium bonds, but in return the issuer receives more bond proceeds which results in the issuer issuing less par amount of bonds to generate the same amount of net bond proceeds. In the end, the net result is less total debt service for the issuer despite the higher coupon rates. Thus, using just the interest rates (as opposed to some type of true interest rate) could be potentially misleading by greatly overstating the amount of interest that would be actually paid on the bonds when issued if such bonds are ultimately issued at a premium.

One last point to mention on this topic is that stating the dollar amount that will be required to pay interest in the future is misleadingly high if there is not an adjustment for the time value of when the interest will be paid. Under even modest inflation, $1.00 to pay an interest payment 25 years would translate to only a fraction of that amount in today's dollars.

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[1] This is actually stricter than required by current law, which requires that the first maturity be within three years of the issue date, and that no later maturity may be more than four times the amount of a prior maturity (G.S. 159-65).

We also have concerns with the provisions that directs the issuer to utilize the highest interest rate charged when looking at the immediately preceding years for a term equal to the maximum issue term of the proposed bond. At face value, this seems to suggest that for a 20-year bond issue, the estimate of interest should use the highest interest rate charged over the past 20 years. We are not certain that is what was intended, but if so, we would think that considering interest rate data over this long period of time would likely lead to inaccurate estimate. For example, for a brief period of time during the financial crisis, interest rates spiked to abnormally high levels. We would submit that using these abnormally high historical rates would not give voters an accurate picture of what is reasonably expected. We are not certain what is meant by the "maximum issue term" of the proposed bond[s]. Would this be the maximum term allowed by statute (which in many cases could be up to 40 years) or what was reasonably expected. We believe that it would be improper to assume a longer term (and a higher rate) than what is reasonably expected.

We would reiterate that, as described above, the bond authorization process already requires the finance office of the unit to prepare and file with the governing body (as well as publish twice in the local newspaper) a statement of total estimated interest over the expected life of the issue based on reasonable assumptions regarding the same (see G.S. 159-55, 159-56 and 159-58). Thus, the disclosure of estimated interest is already adequately addressed.

(b) Effect on Property Tax Rate. Senate Bill 265 would require disclosure of "the unit's increase in property tax liability increase for each ten thousand dollars ($10,000) of property tax value necessary to service the debt." While we believe that information relating to potential impact on tax rates is important information for consideration, we have concerns with the technical requirements of the language as currently drafted.

First, it is possible (and often the case) that the proposed bonds are not expected to require a property tax increase for various reasons such as (1) current tax revenues already being sufficient to service the debt absent material changes, (2) an increase in tax revenue may be anticipated due to anticipated growth in the tax base (by annexation, new construction or otherwise), (3) because sources of revenue other than ad valorem tax revenues are expected to be used to pay debt service on the bonds or (4) debt service on outstanding debt declining or ending in future years, freeing up those funds to pay debt service on the new debt to be issued. While a governmental unit is required to pledge its taxing power to secure general obligation bonds, it is quite common for other sources of revenue to be used to actually service the debt. For example, many counties use lottery reciepts to service debt on school bonds, and water and sewer revenues are generally used to pay debt service on general obligation bonds issued for water and sewer purposes. It is not clear in the proposed bill whether, in stating the increase in property tax liability, an assumption needs to be made that a tax rate increase will be made to service all of the debt relating to the proposed bonds – even if this is not what is expected.

Second, this requirement assumes that property tax values in the unit remain static over the life of a bond issue. In practice, as a City or County grows, its tax base increases, meaning that the property tax burden can be distributed among a larger tax base, decreasing the burden on a given property. An estimate of the cost per $10,000 of taxable property value in 2021 will not be an accurate statement of the property tax attributable to bonds issued through 2045. Assuming reasonable growth of the tax base, the amount per $10,000 of taxable property needed to provide debt service on a bond issue should be much less in year 20 than in year one. We often see issuers provide an estimate of any tax increase that will be required over a short term horizon to service the debt, but calculating the amount over extended periods becomes more speculative the further out the projection is made. Of course, the contrary could also happen where a unit's property tax base may decline over time resulting in the possible need of a tax rate increase to cover debt service costs. Ultimately, unless the unit has made a definitive decision to increase the tax rate for the purposes of servicing the debt service on the proposed bonds, any information relating to increase in tax liability is simply just an estimate and can likely change dramatically prior to the time the bonds are actually issued and during the duration of the bond issue.

Third, as noted above, the typical general obligation bond in North Carolina is structured using level principal, not level debt service. This means that debt service will decline over time on a typical bond issue, meaning that the tax levy needed to service the debt will decrease every year. A statement of the amount of tax increase needed to cover debt service in the first year would significantly overstate the effect of the tax increase if the issuer reduces taxes in future years as debt service declines.

(c) Information Regarding "Two-thirds" Bonds Capacity. Senate Bill 265 would also require the LGC order authorizing the bonds and the ballot question to state that a voted bond authorization would allow the issuing unit to issue non-voted "two-thirds" bonds without voter approval in future years. This provision is in reference to the constitutional and statutory provisions that allow the issuance of new general obligation debt in a fiscal year in an amount up to two-thirds of the net reduction of general obligation debt in the prior fiscal year.

We believe that the provision proposed exaggerates how much debt can be issued under the two-thirds provisions. The two-thirds calculation is not as simple as taking the amount of bonds authorized and concluding that another two-thirds of that amount can and will be issued. The calculation is made annually based on the net principal reduction of all outstanding general obligation debt for the given fiscal year (not on an issue by issue basis). If there have been any new general obligation debt issues during a fiscal year, then in all likelihood there will not be a net principal reduction during such fiscal year. In addition, often the net debt reduction, and two-thirds of that amount, do not result in an eligible two-thirds amount that is economically feasible to pursue. While we do not have the amount, from our experience, we believe that only a small percentage of general bond voted authorizations are "reincarnated" into non-voted two-thirds bonds.

4. Further Discussions. While we have stated our views and technical observations above, we want to underscore that we and the other bond lawyers practicing in North Carolina are happy to discuss ways that the authorization procedures for bond authorizations will appropriately and accurately provide relevant information to voters during the general obligation bond process to the extent currently not being provided. However, as we have tried to make clear above, we do not think the ballot question itself is the vehicle for providing such information. It occurs to us that modern technology can be a very useful tool in this process. As we have noted, many issuers holding bond referenda are currently utilizing their websites (as well as other written materials) to provide helpful Q&A and other information pertinent to the proposed bond issue. We think the use of these types of vehicles provides a useful and proper forum for full and fair disclosure with room for nuance that this very complex issues require.

We look forward to providing further assistance on this matter as may be helpful to you.